Southern Cross Views on the FCC's Universal Service Contribution FNRPM

15 March 2013

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1. Background on Southern Cross

Introduction to Southern Cross

- Southern Cross Cables Limited (“SCCL”) is a leading Australasian supplier of international capacity to carriers, ISPs, content providers, and large enterprises.
- SCCL provides almost all of New Zealand’s international connectivity and a significant percentage of Australia’s international connectivity.
- SCCL owns and operates the Southern Cross Cable Network (“Southern Cross”), a trans-Pacific undersea cable network connecting Australia, New Zealand, Fiji, Hawaii, Oregon, and California with a triple-ring configuration.
- Southern Cross entered into commercial service in November 2000; its capacity was upgraded tenfold in 2007 and is currently undergoing yet another upgrade, with services now being sold through the year 2025.

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Network and Corporate Ownership

- SCCL owns and operates the wet segments (beyond the territorial seas of the United States, Australia, and New Zealand) of Southern Cross.
- Pacific Carriage Limited ("PCL") owns the associated U.S.-territory portions of Southern Cross.
- Verizon subsidiaries own and operate the Spencer Beach (Hawaii), Oregon, and California landing facilities. The Kahe (Hawaii) landing facilities are leased by PCL and operated by Hawaiian Telcom, Inc.
- SCCL and PCL are both Bermuda limited companies 50-percent owned by Telecom New Zealand Limited. SingTel Optus owns a 40-percent interest in each entity, while Verizon Business owns a 10-percent interest in each entity.

2. Background on Undersea Cable Infrastructure and Services

Undersea Cables Provide Almost All U.S.-International Connectivity

- Undersea cables carry more than 95 percent of U.S.-international Internet, voice, and data traffic, a market share that continues to increase.
- In addition to commercial traffic, undersea cables carry most U.S. Government civilian and military traffic, as the U.S. Government does not own and operate undersea cables to provide telecommunications.
- A substantial portion of undersea cable infrastructure landing in the United States functions to provide consumers in foreign markets with access to U.S. Internet content.
- A significant percentage of the customers purchasing capacity on cable systems landing in the United States are located outside the United States.

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Undersea Cables Compete Little with Satellites

- Undersea cables and satellites compete only on a few thin routes, which continue to decline in number.
- Undersea cables offer significantly higher capacity, lower latency, greater reliability, and lower costs.
- Low latency is critical for real-time applications, such as live video and financial services trading.
- Capacity of undersea cable systems can be upgraded after deployment, whereas capacity for satellites cannot be.

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Most Capacity Sold on a Wholesale, Long-Term Basis

- Most capacity is sold on a wholesale basis in large increments, ranging from a STM-4 to a 10-gigabit wavelength .
- A significant percentage of the international undersea cable capacity serving the United States is sold on an indefeasible right of use (“IRU”) basis for a term of years (with a 10-, 15-, or 20-year term) or for the useful life of the cable system, plus separate quarterly charges for operations and maintenance (“O&M”).
- Some IRU agreements provide for large lump-sum payments up front, while others provide for periodic payments through the term of the IRU.
- Capacity is also sold on a long-term lease basis.
- Significant amounts of capacity are sold on a ring-configuration or protected basis, meaning that the actual traffic carried may not touch the United States at all , even though the system has a U.S. landing.

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Sales Provide Long-Term Supply at a Known Price

- The advantage of an IRU, from the purchaser's perspective, is that it provides the security of supply at a known price.
- For many sellers, an IRU represents a way of funding the cost of construction through system pre-sales.
- Additional capacity can ordered under original agreement using an order form or (in the case of Southern Cross) using a new agreement with the same standard terms and conditions.
- These long-term arrangements make recovery of later-imposed regulatory charges difficult, if not impossible. ***Aware of the FNPRM's proposals, customers are already communicating to Southern Cross their opposition to pass-throughs of such charges.***

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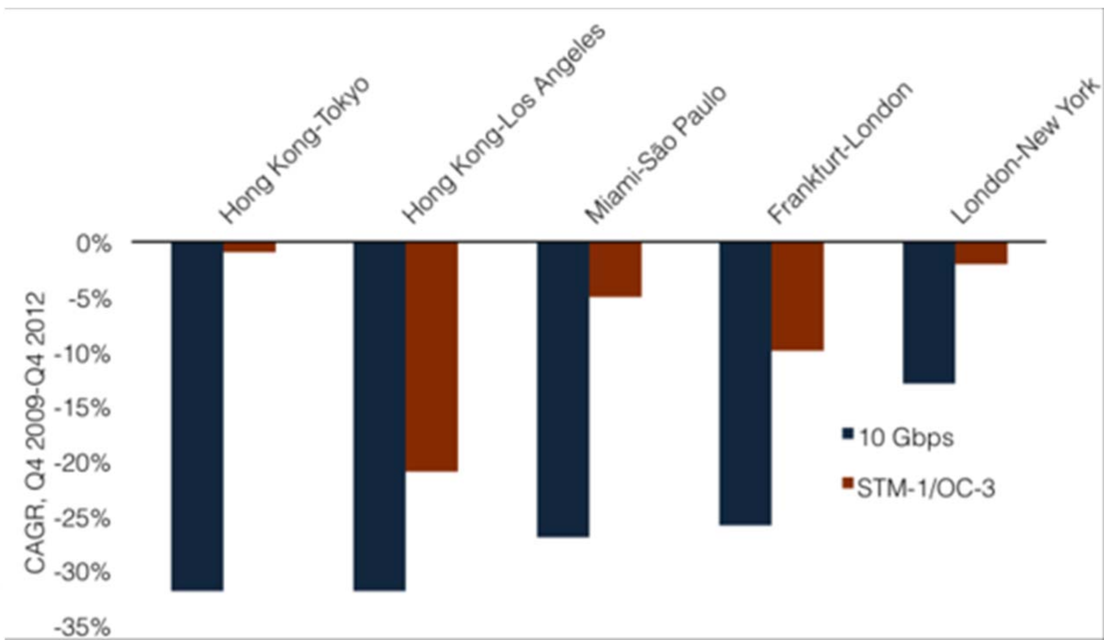
Capacity Prices Continue to Erode

- Capacity prices have declined significantly over the last 15 years.
- Between Q4 2011 and Q4 2012, median monthly lease prices for 10 Gbps wavelengths on key global routes fell 37 percent, while prices of 155 Mbps STM-1/OC-3 circuits declined 12 percent.



Source: TeleGeography

Sensitivity to Regulatory Charges

- Undersea cable operators are acutely sensitive to regulatory charges associated with various landing options and routinely factor such costs into their decisions to land in particular countries.
  - Sensitivity is heightened by razor-thin margins, declining capacity prices, and the difficulty of recovering such charges and fees long after payment has been made for services.
  - This si true of both new market entrants and existing operators seeking to replace an existing cable that has outlived its commercial or technical usefulness.
- Southern Cross itself abandoned use of a purpose-built cable station in Monterey Bay, California, and landed in Oregon instead due to permitting costs. Other operators increasingly favor Oregon over California.
- Operators increasingly discuss the attractiveness of landing in Canada due to the impact of U.S. federal regulatory charges, recent relaxation of Canadian foreign ownership limitations, and U.S. proximity. Canada's universal service assessments are a 1/24th of U.S. assessments.

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Undersea Cables and USF

- As of 2012, most undersea cables landing in the United States are operated on a non-common-carrier basis. Such operators are not even required to register with the Universal Service Administrative Company ("USAC") if they qualify for the international-only exemption or the LIRE.
- Even for common-carrier operators, however, they need only file Form 499-A on an annual basis.
- Most IRU agreements and capacity leases do not permit pass-throughs of USF contributions to customers. This is unsurprising, given the FCC's categorical statements about the international-only exemption over the last 15 years and the Fifth Circuit's findings in *TOPUC v. FCC* in 1999 with respect to a statutory provision that remains unchanged by Congress.

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3. Adoption of FNPRM Proposals Would Cause Severe Economic Distortions

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FNPRM Proposals Would Cause Collateral Harms to Undersea Cable Operators

- The FNPRM’s proposed remedies are overly broad and purport to remedy one economic distortion involving pre-paid calling card providers even as they would create new economic distortions in the market for international undersea cable capacity.
- Nowhere does the FNPRM consider the differences in the markets for international undersea cable services—wholesale, long-term capacity—and for pre-paid calling card services.
- Reliance by undersea cable operators on the international-only exemption and the LIRE does not create competitive distortions.

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Undersea Cable Operators Lack the Cost-Recovery Options of Retail Providers

- A provider of retail telecommunications services can, in an era of detariffed service offerings, simply give notice to its customers of the pass-through (via inserts in consumer bills and updated web site disclosures), consistent with the FCC's truth-in-billing rules.
- Similarly, a prepaid calling card provider can easily adjust the retail prices of its products to recover the costs of increased USF contributions.
- By contrast, undersea cable operators would need to attempt to renegotiate hundreds of IRUs and capacity leases to permit the operator to pass through the costs of USF contributions.
  - Such costly efforts usually fail, as the operator would be seeking to alter fundamentally the economic terms of long-term arrangements negotiated in reliance on longstanding international-only exemption and the LIRE.

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FNPRM Proposals Would Harm Compliant Operators Disproportionately

- Operator attempts to pass through such charges often fail due to strategic behavior of non-compliant operators, which offer lower pricing to customers and undermine the efforts of compliant operators to establish a regulatorily-compliant price.
- This was the case with international undersea cable operator attempts to pass through capacity-based FCC regulatory fees, where non-compliant operators created a “race to the bottom” in international capacity markets, despite the FCC’s best efforts to ensure compliance.
- As with regulatory fees, strategic behavior with USF charges would likely outpace enforcement efforts.

FNPRM Proposals Would Eliminate Operating Margins

- Unsuccessful recovery of USF contribution costs from even a minority of customers could turn certain international undersea cables into loss-making enterprises.
  - Operating margins on many routes are already razor-thin.
  - Capacity prices continue to fall.
- Customers outside the United States consistently object that “domestic assessments” such as USF contributions and regulatory fees are part of the operator’s administrative overhead and should not be passed through to customers.

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FNPRM Proposals Would Deter New Investment and Services

- The FCC has long recognized the importance of encouraging investment and new services and adopting market-entry, licensing, and fee rules that promote such investment and services.
- By creating unfavorable economic conditions for U.S. landings, the FNPRM proposals could deter new U.S. cable landings and encourage operators to land in other countries, particularly Canada.
- These proposals could also encourage Internet content providers (including online video providers) to shift content creation and storage outside the United States, perhaps abetted by the spectacular growth of content delivery networks ("CDNs").
- Such outcomes would harm the telecommunications, Internet, and entertainment sectors of the U.S. economy.

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FNPRM Proposals Would Harm National Security

- If undersea cable operators were to divert landings to Canada or Mexico in order to avoid increased U.S. regulatory costs, the result would adversely impact national-security interests as articulated by various U.S. Government agencies.
- The absence of U.S. landings would deprive the Commission of licensing jurisdiction over such cables and consequently reduce U.S. Government oversight of the supply and operational arrangements for such systems.
- Fewer U.S. landings would also reduce the resiliency of U.S. international networks, making those networks more vulnerable to outages terrorism, and espionage.

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LIRE Elimination Would Harm Competition in Interstate Services

- Even if the FCC were to retain the international-only exemption, its elimination of the LIRE, without any functional equivalent, could still lead international undersea cable operators to cease provision of ancillary domestic interstate services.
- Such an outcome would reduce competition in the market for such services.

FNPRM Proposals Could Encourage Retaliation and Revenue-Seeking by Foreign Governments

- As capacity is often sold on an end-to-end or ring-configuration basis, such services would arguably fall within the regulatory jurisdictions of each landing country.
  - Southern Cross lands in three countries (Australia, Fiji, and New Zealand) in addition to the United States.
  - Level 3's South American Crossing system lands in five countries (Brazil, Argentina, Chile, Panama, and Peru) in addition to the United States.
- If other countries were to make similar assessments on the same revenue streams for international services, such assessments could quickly equal or exceed the total revenues for an undersea cable system.

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4. Extraterritoriality and Improper Subsidies

FNPRM Proposals Lack Jurisdictional Nexus

- The FNPRM proposals would improperly subsidize the FCC's domestic universal service programs with contributions from international undersea cable operators for activities they conduct predominantly in foreign jurisdictions or beyond the limits of any nation's jurisdiction.
- The jurisdictional nexus for assessing USF contributions on revenues from capacity services on international undersea cables is weak at best, and likely impermissibly extraterritorial.

FNPRM Proposals Differ from Settlement Rate Benchmarks

- With benchmarks, the FCC sought to regulate the rates paid by domestic carriers for the termination of U.S.-originated traffic in foreign markets, relying on its regulatory powers to regulate rates and contracts pursuant to Sections 205(a) and 211(a) of the Communications Act, respectively.
- Here, the FNPRM would have the FCC collect a regulatory assessment on revenues for end-to-end services between the United States and a foreign country, where the customer is—as often as not—located in a foreign country.
- The FNPRM assumes—improperly—that all of the revenues for such end-to-end capacity services are properly assessable simply because the capacity may originate or terminate in the United States (though not necessarily even on the PSTN).
- In fact, most of those revenues are associated with transport across geographical jurisdictions beyond the 12-nautical-mile limits of U.S. territory, and with origination or termination (whether on the PSTN or not) in one or more foreign countries.

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FNPRM Proposals Inconsistent with *Benchmarks Order* Rationale

- The FNPRM proposals would promulgate the very sort of measures the FCC fought in the *Benchmarks Order,* in which the FCC articulated the principle that carriers and their customers in one country should not subsidize another country's universal service program:
  - "[W]e disagree that foreign termination services from certain countries should be required to finance a disproportionate share of network costs, or that foreign carriers should have the ability to impose hidden, discriminatory universal service obligations on termination services for foreign-originated calls."
  - "Discriminatory . . . universal service obligations that are levied disproportionately on foreign-originated calls clearly violate the[] principles" of "transparent, nondiscriminatory and competitively neutral" universal service obligations.
  - "Foreign governments are free to choose their own policies, but international law does not require U.S. consumers to subsidize those [universal service] policies."

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5. Legal Infirmities

Section 254(d) Grants Jurisdiction over Interstate Providers Only

- Section 254(d)'s unambiguous language denies the Commission jurisdiction to assess USF contributions on providers of exclusively foreign communications.
- Section 254(d) does not support the FNPRM's novel reading, which asserts that Congress was only distinguishing federal authority from state and territorial authority. When Congress meant to distinguish federal from state and territorial authority, it did so expressly, as reflected in the Commission's longstanding interpretation of Section 254(d).
- Congress clearly intended to exclude providers of exclusively foreign communications from contributing and expressly rejected language in the original Senate bill that would have included foreign communications.

FCC's Ancillary Jurisdiction and General Powers Do Not Authorize the FNPRM Proposals

- The specific provisions of Section 254(d) trump the general ones in Title I and Sections 201(b) and 251(b)(4), as generally accepted statutory-interpretation rules provide that where specific and general provisions conflict, the specific provision governs.
- Section 254(d) trumps the earlier-adopted provisions of Title I and Section 201(b), as generally accepted statutory-interpretation rules provide that where earlier and later-enacted statutory provisions conflict, the later-enacted provision governs.

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The Fifth Circuit's Decision in *TOPUC v. FCC* Precludes the FCC from Simply Eliminating the LIRE

- The court found that the FCC's "contamination theory" of jurisdiction, violated Section 254(d)'s "equitable and nondiscriminatory" requirements, noting that the FCC's assessment of all end-user interstate and foreign communications revenues if a provider had any interstate revenues—"allow[ed] it to impose prohibitive costs" on a carrier whose USF contributions exceeded its interstate revenues and "is 'arbitrary and capricious and manifestly contrary to the statute.'"
- The court further found that the FCC's interpretation was discriminatory because it harmed certain providers of foreign communications more than others, requiring such providers "to incur a loss to participate in interstate service."
- *TOPUC v. FCC* has not been overruled or superseded.

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Predominantly International Operators Often Provide Some Interstate Services

- In 1997, the FCC concluded that it was equitable and nondiscriminatory to assess contributions on international services revenues, noting that "any disparity among providers should be minimal, since most international revenues are today earned by carriers that also provide interstate services."
- Now, however, there are now many providers that earn most of their foreign-communications revenues without providing any (other than ancillary) interstate communications due to the facts that:
  - The world's undersea telecommunications cables are no longer owned and operated by carrier consortia, with one national champion in each market.
  - Trade in basic telecommunications services has been liberalized within the World Trade Organization ("WTO") framework
  - The United States no longer requires a showing of "effective competitive opportunities" for the landing of cables connecting to WTO-member countries, making end-to-end ownership of undersea cables possible without a U.S. landing party.
  - Most of the world's undersea cable connectivity is used for transporting Internet content, rather than voice and data transmission.

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FNPRM Proposals Would Violate Export Clause of U.S. Constitution

- The Export Clause states, “No Tax or Duty shall be laid on Articles exported from any State,” pursuant to which the U.S. Supreme Court has broadly exempted from federal taxation both goods and services.
- The Export Clause permits user fees that reflect a fair approximation of services, facilities, or benefits to the exports “designed as compensation for Government-supplied services, facilities, or benefits.”
- By imposing *ad valorem* (rather than benefit-calibrated) charges on providers of exclusively or predominantly international undersea cable services, most of which are used to deliver Internet content to foreign customers and do not use the PSTN, the FNPRM proposals violate the Export Clause.

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FNPRM Proposals Would Violate U.S. WTO Commitments

- WTO General Agreement on Trade in Services ("GATS") prohibits non-transparent discriminatory, and competition-distorting measures regarding universal service.
- ***Non-Transparent***: Existing operators did not know of the universal service obligation before entering the market, given the FCC's longstanding international-only exemption and LIRE.
- ***Discriminatory***: Fifth Circuit found in *TOPUC v. FCC* that the FCC's pre-LIRE regime was "'discriminatory' because the agency concedes that its rule damages some international carriers . . . more than it harms others."
- ***Competition-Distorting***: Proposals would create significant economic distortions for both existing and future undersea cables, making it uneconomic to offer certain services or to land new cable systems in the United States.

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6. Recommendations

Recommendations

- The FCC should retain the international-only exemption.
- The FCC should retain the LIRE, addressing as necessary any disparity between the LIRE's 12-percent threshold and the actual contribution factor.
- To address any concerns about competitive distortions arising with pre-paid calling card providers, the FCC should pursue a targeted remedy that does not cause collateral harm to international undersea cable operators.
- If the FCC decides to adopt a connections-based methodology for USF contributions, it should exclude international services altogether, as there is no "connection" within its jurisdiction.

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